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TO: Mayor Raymond L. Flynn

FROM: Economic Development Working Group

RE: Opportunities Lost: Economic
Impact of the State Fiscal Crisis
and the Credit Crunch

DATE: April 30, 1990

Executive Summary

The major challenge of the 1990s is to keep Boston a strong and healthy economic community. Boston enjoyed unprecedented economic gains in the 1980s and we must ensure that economic development opportunities and jobs continue. However, we are deeply concerned about the Commonwealth's prolonged fiscal crisis and the lack of a sound gameplan to achieve economic recovery.

The effects of fiscal paralysis at the state level may soon be dwarfed by the unprecedented credit crunch caused by shortsighted federal regulators. Unless both problems are addressed immediately, more jobs will be lost and economic recovery will be delayed indefinitely.

Since October of 1989, City officials have been actively seeking new investment capital outside of Boston to move development projects in the pipeline forward. In discussions with business leaders and respected economists both in Massachusetts and in cities around the country such as New York, Chicago, Washington, D.C., and Cleveland, the effects of the credit crunch and the state fiscal crisis have dominated. These twin crises have frustrated our attempts to attract new investment dollars for the regional economy. Based on reports in such widely-read newspapers as the Economist, The New York Times, and The Wall Street Journal, the most optimistic investors were hesitant to move forward until the situation in Massachusetts is "cleaned up."

At the "Economic Outlook Conference" in November 1989, the New England Economic Project, a consortium of leading banks, insurance companies, and other businesses forecast a recovery in the State's economy in late 1991. In March of this year, Peter Kozel, Shawmut Bank's Chief Economist, reiterated this prognosis. However, the state's prolonged fiscal crisis and growing credit crunch make the potential for the recovery in 1991 remote. The recovery could be delayed by a year or more. The impact of even a one year delay in the recovery would be felt on many fronts including: lost jobs, lost tax revenue to the state, fewer housing starts, a worsened

state deficit, and a shrinking tax base for the City and Commonwealth.

Federal regulators' seizure of Home Owners Federal Savings Bank, the largest savings and loan in Massachusetts, is further evidence that local sources of the credit necessary for economic expansion are being cut off. At the same time, outside investors will not finance the Massachusetts economy until the state fiscal crisis is resolved.

According to widely-held views, we could normally expect a recession to last twelve to eighteen months, as did the recessions of 1974-75 and 1981-82. The current situation is different, in that local sources of credit are becoming unavailable at the same time that outside investors wait for a solution to the fiscal crisis. Given the political inability to resolve the fiscal crisis, we can expect the recession to last longer than normal. In addition, Massachusetts will be suffering from the same inflation rate as the rest of the country, while our economy slows faster than that of the nation as a whole -- meaning that the local recession will feel more severe than it would at a time of national economic recession, when we would expect a reduction in the rate of inflation.

I. Fundamental Strengths of the Boston Economy

Boston in the 1980s built a diverse economy responsive to the economic realities of the decade. Boston's broad-based services economy produces annual average wages and productivity (gross product per worker) higher than that for the metro region, the state, and the nation. During the years 1982 to 1988, Boston gained 71,000 jobs. Real wages, adjusted for inflation, have risen in Boston, in comparison with wage stagnation nationwide. During this period, the City attracted an investment of \$6.8 billion in private development construction. A 40 percent growth in the City's stock of office space was accompanied by a 30 percent growth in office rents, in the five years from 1983 to 1988. Careful metering of development maintained commercial vacancies within a healthy range.

Of the \$149.7 million growth in Boston's annual property tax revenues between Fiscal Year 1984 and Fiscal Year 1989, \$62.9 million (42 percent) was due to construction development, \$42.9 million (29 percent) was attributable to the other growth categories of new accounts, subdivisions, and the like, and just \$43.9 million (29 percent) was the 2 1/2 percent tax increase allowance permitted under Proposition 2 1/2. By Fiscal Year 1989 cumulative growth revenues (development construction, new accounts, and their accumulated 2 1/2 percent annual "earnings") totaled \$105.8 million, or 22 percent of that year's \$438.7 property tax levy. These are funds that the City has been able to put to work



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directly for schools, public safety, community development, and social services.

A measure of the relative prosperity that economic growth brought to Boston is the reduction of family poverty from 18 percent in 1980 to 11.5 percent in 1989. The lowering of poverty in Boston was all the more notable in comparison with other large cities where poverty has risen, according to a report of the Boston Foundation.

During the period from 1982 to 1988, the Bay State generated 700,000 net new jobs, personal income growth was the second highest among the Nation's states, and, in 1988, the level of per capita income was third highest. The economic gains of the 1980s in Boston and the Commonwealth were unprecedented. The 1990s hold opportunities for steady economic expansion and further diversification of the regional economy.

Boston has the intellectual resources, skilled labor, infrastructure base, and sophisticated business sector needed for a new period of economic growth in the 1990s. There are a total of twenty-five medical research institutions in Boston; seventeen are research hospitals, five are non-profit research institutes and three are medical schools. There are a total of 2.6 million square feet of research space housed in these institutions. These institutions have expressed a demand for more than 2.0 million square feet of new research space over the next several years. Hospitals and medical schools have submitted plans and proposals for 1.96 million square feet of additions. The Boston Area leads in National Institute of Health medical research grants, on a per capita basis, and is now garnering a flow of research grants from private concerns, including Hoechst, Shiseido, Squibb and Dupont, totaling \$185 million. These grants hold promise for diagnostic instrument and pharmaceutical spinoffs. Massachusetts, with three of the top ten software companies in the nation, in terms of revenue, as of mid-1989, is in the vanguard of the computer software industry. There is also significant potential for expansion of the tourism and hospitality industries, keyed by a new New England Aquarium and Boston Garden.

National and world markets continue to evolve to demand those things that Boston is well positioned to produce: sophisticated business services, health care, medical research, biotechnology, computer software, instruments, and pharmaceuticals. In short, the fundamentals required for Boston to grow in the economy of the next decade are in place.

Boston's growth prospects are critical to the Commonwealth as a whole. Boston, with ten percent of the population of the Commonwealth, has seventeen percent of the jobs, and generates twenty-four percent of the value of the production of goods and services and twenty-two percent of all state tax revenues.

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II. The Present Economic Environment

Notwithstanding the fact of a fundamentally sound economy, Boston and the Commonwealth have entered an environment of slower growth and economic uncertainty not experienced since the 1970s.

Respected economic observers have projected that this new economic environment reflects cyclical forces. The New England Economic Project, a consortium of leading banks, insurance companies and other businesses, forecast a continued slowdown in 1990 with recovery in 1991, in the Bay State, at their "Economic Outlook Conference" in November 1989. Peter Kozel, Shawmut Bank Chief Economist, and the NEEP forecaster for Massachusetts, reiterated this prognosis, in a basically upbeat replay of the November message, at the Sixth Annual New England Real Estate Conference, in March of this year.

Commentators have stated frequently in articles and newspaper quotes that Massachusetts "is not Texas" and that the present environment of slower growth is a readjustment and not a bust characterized by widespread unemployment, business failures, and substantial declines in business and real estate values.

The projected recovery of the Massachusetts economy is not a sure thing, however. The growth potential inherent in Boston's and the region's fundamental economic strengths can be squandered and the Commonwealth can enter into a period of prolonged economic stagnation, or worse, if it becomes impossible to bring public and private investment to the City and the region. Two factors are threatening to choke off investment: (a) the state's fiscal crisis and (b) the constriction of lending activity by area banks brought on, in significant part, by the intensity of regulatory scrutiny by federal bank regulators.

III. The Fiscal Crisis

The Commonwealth's fiscal crisis and the continuing political paralysis in the state legislative and executive branches imperils investment in the Boston economy in several ways.

Private, out-of-state investors are discouraged from investing in the City by fears that the Commonwealth is incapable of pursuing an effective or stable economic policy. The spectacle of policy paralysis at the state level is compounding negative perceptions regarding the state of the New England economy and its prospects for recovery. A sense that the state's political leaders are not rallying to address critical economic challenges is undermining perceptions of the region as a growth area for new investment.

A January 19, 1990 article in the Harvard University Gazette, headlined "Massachusetts Struggles with a Budget Crisis", surveyed expert opinion, and reported that "the biggest problem the state

aces today is chronic indecision among government officials. This failure has created an uncertain business environment that has firms thinking twice about making further investments in the Commonwealth."

This lack of investor confidence in the State government's ability to manage the economy is evidenced by the four downgradings of the Commonwealth's bond rating in the last year. The lowered bond rating could cost Massachusetts taxpayers as much as \$500 million over the next ten years -- money which will never be recovered. By comparison, this amount is seven times the nominal value of all linkage contracts secured by development in Boston from 1984 to 1989. According to Cathy Daicoff, Chairwoman of the Massachusetts Credit Committee for Standard & Poor's in New York, the bond rating will not change "until we see a sustained period of financial stability."

In addition, Massachusetts has a large agenda of public infrastructure investment totaling \$11 billion which may be imperiled by policy paralysis. This \$11 billion agenda represents a counter-cyclical infusion of jobs and money, and the rebuilding and expansion of the necessary infrastructure for growth into the 21st century. The agenda includes the Boston megaprojects -- the Central Artery and Third Harbor Tunnel projects, and the Harbor Clean-Up project -- as well as the development programs of the State Department of Public Works, Massport, the Massachusetts Turnpike Authority, and the Massachusetts Bay Transportation Authority. These projects can provide critical construction employment and contribute importantly to job growth in many other local industries, including office-based businesses. At present, the fiscal benefits of the state megaprojects are not being realized because of the delays in their commencement.

Although the megaprojects are to be financed primarily with federal aid, a significant state financial contribution is also required. In addition, effective state leadership able to guide these massive projects and defend the necessary appropriations in Washington will be needed for their completion. Like the recovery of the Boston and Massachusetts economies as a whole, the megaprojects are not a sure thing. The loss of one or more of these projects would undermine economic prospects for the City and the region.

IV. The Worsening Credit Crunch

For the past several months, Boston area businesses have been experiencing the consequences of tightening access to credit. While the Federal Reserve Board's recent studies attempt to demonstrate that the issue is a minor one, real firms, employing real people are finding their credit disappearing overnight.

The Federal Reserve Board statistics tend to downplay the lack of credit by aggregating business lending, thus obscuring the problems facing small and medium size firms. Chairman Greenspan conceded that tougher lending standards have "potential effects on the level of local economic activity." Bankers acknowledge that they have made some changes recently. In the six-state region tracked by the Boston Federal Reserve Bank business loans at large banks have fallen 7.9% since the beginning of the year, or about \$1.8 billion, to \$20.8 billion as of April 11. This loss of nearly \$2 billion will cripple the expansion ability of smaller firms.

Boston and other major Massachusetts cities (such as Lowell, Lawrence, and New Bedford) face a critical moment in their economic history. At the very time that our inner-city communities face the greatest need for economic development, that growth is threatened. Only balanced and steady economic development, coupled with job training and education, can assist Boston and other major cities in the quest to maintain the economic health and the well-being of inner-city neighborhoods. If existing businesses cannot secure credit to expand and thrive, and new firms perceive the region as closed to investment, then long-term stability of these cities may be in jeopardy.

As reported in the New York Times, many small and medium sized companies are finding loans tougher to get. With increasing frequency, their banks are withdrawing credit lines, demanding that more collateral be put up to back loans, trimming their estimates of the worth of the collateral that is offered and taking a generally more suspicious view of borrowers' growth forecasts. There has been a slowdown in all aspects of lending. The extent of the banks' conservatism is evidenced by the sharp reduction in the number of home equity loans, traditionally considered one of the safest loans. Lending for real estate and to smaller companies has been most dramatically crimped in the Northeast.

"There is no doubt that small and medium-sized companies are having problems getting credit," Richard F. Syron, president of the Boston Federal Reserve Bank has said. "It's not enough to expect a major impact on G.N.P., but that is scant comfort to someone who borrowed a \$150,000 and is caught in a squeeze not their own making."

As usual whenever credit becomes scarcer, small businesses are likely to feel the pain sooner and more severely than larger businesses. Yet small businesses are the largest generator of new jobs. For example, construction loans in New England dropped 9.1 percent last year, after annual increases ranging from 25 percent to 52 percent in the previous four years.

Our recent discussions with local and national business leaders indicate that the most frequent complaints people have about the regulators is that they are excessively and arbitrarily

marking down the value of real estate loan portfolios. In many instances the bankers say the examiners are reviewing loans that they reviewed favorably only a year ago and marking down the value or forcing the banks to increase loan loss reserves, even when there have been no late payments or other problems on those loans.

V. Small Business Survey

Joseph Blair, Executive Director of the Massachusetts Industrial Finance Agency (MIFA), has testified at a hearing held by the House Small Business Committee on the results of a survey of small Massachusetts businesses conducted by MIFA. The results of survey are disturbing.

To date the MIFA has received 228 responses from small businesses that have borrowed through MIFA programs. Of the 228 respondents, 106 companies indicated significant difficulties obtaining credit in the past six months. All the companies surveyed sold bonds through MIFA that were either purchased by the banks or carried bank letters of credit and thus the companies generally have good credit backgrounds. None of these companies are start-ups or the products of highly leveraged transactions.

A brief summary of the specific problems reported by these companies follows:

- o 57 respondents indicated that their banks either capped, suspended, or renegotiated the terms of lines of credit, resulting in a diminished supply of working capital needed to fund everyday business operations, such as payrolls.
- o 18 indicated that their banks had changed the classification of their loans without good reason, resulting in accelerated payments in some cases, despite the fact that they were current on their loans.
- o 43 indicated that their banks had reappraised the value of collateral and, in many cases, asked for additional security for existing loans. By lowering the appraised value of the collateral, banks are effectively reducing the amount of money they will lend to companies.
- o 37 indicated that banks made their loan covenants tougher.
- o 85 indicated that they had applied for additional capital in the past six months and that 29 were turned down. Many others are awaiting a decision

on their applications and are experiencing unusual delays.

The MIFA study provides valuable evidence of the difficulties now faced by the Massachusetts companies in obtaining credit. It is clear that tighter rules imposed by bank regulators are a contributory factor -- although not the only factor -- to the problem. The new, tougher standards imposed by the regulators have made banks much more hesitant to extend credit.

We all know that bad loans have been made by every bank in this country, and by banks in this region. We also know that because of the disasters in Texas and the Southwest economy, regulators began seeing our slowdown as a potential meltdown -- analogous to the prolonged collapse of the single product, petroleum-based economies of the Southwest.

Insofar as federal reviews of local banks have been predicated on assumptions about the nature and direction of the regional economy, these underlying policy assumptions about the economy's direction should be subject to scrutiny in an accountable public forum. This is not just another bureaucratic exercise; we must not bring upon ourselves an economic downturn because we were not willing to ask the regulators the appropriate policy questions.

VI. The Impact of Delay

The slowdown of the Boston and Bay State economies in 1989 and 1990, and the recovery projected for 1991, could be followed by a new era of growth for the 1990s. Prospects for several activities could be complemented by expansion of the new economy -- health services, medical research, biotechnology, computer software, instruments, and pharmaceuticals. Bay State exports could more than double in an expanding world economy. The "peace economy" could free up talent, investment, and federal dollars to strengthen the state economy. Overall, the City could gain 80,000 jobs in the 1990s, and the state 300,000.

But the recovery in late 1991 will not be automatic. It will require sound public sector guidance, and could be lost without solution to the state's fiscal disarray, and relief from bank credit stringency. Without solutions to these twin threats to economic recovery, city and state economic conditions will degenerate and the adverse impacts could be severe. For example, a mere one year delay in the recovery could lead to a worst case scenario described in Table A and including the following:

- o The number of people out of work would rise to more than 240,000, compared to approximately 90,000 in 1988.
- o The State's unemployment rate would rise to 8 percent, well above the national average, following a decade in

which Massachusetts had one of the lowest unemployment rates of any state in the nation.

- o It would lead to the loss of 12,000 jobs in the City and as many as 90,000 in the State in 1990.
- o Housing starts, which averaged 30,000 per year in the State during the mid-1980s, would drop to 5,000 per year.
- o The State's production of affordable housing would come to a halt because of the unavailability of revenues for subsidies.
- o Efforts to reindustrialize the State to offset the steady loss of manufacturing jobs in the 1980s would be stalled if the current financial climate persists.
- o The State's Fiscal Year 1991 deficit, according to the State Revenue Advisory Board, could reach \$1.6 billion. Such a condition would trigger the need for additional borrowing by the Commonwealth at a time when, despite having the third highest per capita income in the country, the Commonwealth has the lowest bond rating of any state.

VII. Conclusion

The political paralysis in state government has already imposed incalculable damage on the Commonwealth's finances and economy, and on the strong image Massachusetts had portrayed across the country. In particular, the inability to resolve the eighteen month budget deficit is responsible for four dramatic reductions in the Massachusetts bond rating, a key indicator of investor confidence in the government's ability to manage the economy. Significant damage has already been done to the people and businesses of Massachusetts. The State's further delay in meeting its responsibilities will only exacerbate the deteriorating economic climate all our cities and towns face.

Even assuming the adoption of a program of taxes and spending cuts to balance the State's finances, the expansion of the private economy will still require greater availability of credit and financing in the regional economy. In contrast to assumptions about State action on the fiscal crisis, there are no indications the Federal Government will soon change its regulatory policies toward lending institutions in New England. Boston area business and political leadership must bring the case for change to the highest level of the Federal Government.

Most importantly, the economic statistics portray a City and Commonwealth in which the human costs of the fiscal crisis and the credit crunch are staggering. Our immediate priority must be the

development of a clear and direct economic recovery gameplan that can be taken to state, federal, community and business leadership. What is missing today in the public and private discourse about these topics is an appreciation of the fundamental connection between these problems and the lives of working men and women in the City and the Commonwealth. This condition must change.

Lee Jackson
Don Gillis
Mary Nee
Lisa Chapnick
John Connolly
Stephen Coyle

TABLE A

Potential Impacts of One-Year Delay In Economic Recovery

	<u>1989</u>	<u>1990</u>	<u>1991</u>
<u>Unemployment Rate</u>			
City	5%	6%	7%
State	4%	7%	8%
<u>Unemployment</u>			
City	15,000	18,000	21,000
State	120,000	210,000	240,000
<u>Jobs</u>			
City	-6,000	-12,000	-8,000
State	-33,000	-90,000	-30,000
<u>Housing Starts</u>			
City	2,500	1,250	500
State	35,000	20,000	5,000
<u>Revenue Growth</u>			
	<u>1990</u>	<u>1991</u>	<u>1992</u>
City	+8%	+3%	-5%
State	+6%	+3%	-3%

